

Employee or Independent Contractor?

Male Voice:

[Slide 1] Good day, ladies and gentlemen, and welcome to your Internal Revenue Service Employee or Independent Contractor conference call. All lines have been placed on a listen-only mode. At this time, it is my pleasure to turn the floor over to your host, Jean Ann Redman. Ma'am, the floor is yours.

Jean Ann:

Welcome to this IRS Office of Federal, State and Local Governments, or FSLG, presentation. I'm Jean Ann Redman and with me today is Lori Stieber. Lori and I are Revenue Agent Government Entity Specialists with the IRS FSLG office. Today we'll share important information to aid employers in classifying workers as either independent contractors or employees. Properly determining worker status up front can avoid costly liability should an audit occur.

Our presentation format allows you to ask questions as you're listening. Take a look now at the lower right-hand side of your screen and see that you can type in a question there. After you type your question, you can hit "Enter" or click "Submit" to send the question to us. You'll be able to download a copy of your questions, along with our answers, a recording of this session, and the slides that accompany it from the IRS video portal soon. Our web address for the materials is www.IRSvideos.gov/governments and is also provided on slide 23 for your reference.

With that, Lori is going to get us started on our topic today.

Lori:

[Slide 2] Hello, I'm Lori Stieber. Many employers assume that they can choose the classification or status of workers. They aren't aware of the factors that must be considered and how they should analyze the relationship between the worker and themselves. Ensuring that employers classify workers correctly is important to the IRS and it's also important to Workers Compensation insurers, the Department of Labor, state governments, the Social Security Administration and of course the workers themselves.

The IRS estimates that employers misclassify millions of workers as independent contractors, instead of employees. By misclassifying employees, employers avoid paying a significant amount of employment taxes and other benefits. Additionally, workers are missing out on the rights commonly associated with employment, such as access to medical and unemployment insurance, disability coverage, retirement plan advantages, leave benefits, workers' compensation protection and Social Security coverage.

Employee or Independent Contractor?

[Slide 3] Today we'll discuss how an employee is defined in the Internal Revenue Code, how to make a determination of whether a worker is an employee or independent contractor so that your classification of workers is correct. We'll also discuss how to report the payments of these individuals to the IRS, what you can do if you can't determine the status of a worker as an employee or independent contractor and finally, we'll introduce you to an IRS program where you can voluntarily correct misclassifications.

You'll understand that the classification of employees is not so much a choice, but rather an informed determination. Jean Ann, let's begin to frame this for our listeners.

Jean Ann:

[Slide 4] First, let's discuss how an employee is defined. Most workers fall under the general common law tests. In some cases, a Federal statute indicates whether an individual is an employee. In other cases, a 218 Agreement states that certain groups are considered to be treated as employees. For example, elected and appointed officials. We'll review those situations first, before we get into the common law rules.

A Section 218 Agreement is a voluntary contract between each state and the Social Security Administration. Section 218 Agreements pull employees in designated jobs of a state or local government into Social Security coverage. These agreements vary by state and entity.

If a Section 218 Agreement covers a job, then the worker is an employee. To read more on Section 218 Agreements, go to Publication 963, Federal State Reference Guide. If you have questions about your own 218 Agreement, you can contact your state Social Security Administrator. The website to find your state's Social Security Administrator is included on the slide at the end of this presentation. Lori, what about elected and appointed officials?

Lori:

[Slide 5] The Treasury Regulations state that elected and appointed officials are considered employees for income tax withholding purposes under Section 3401(c). These workers cannot be considered self-employed for FICA purposes and so are deemed employees. In general, if an individual is elected or appointed to perform services as an official of a government entity and the remuneration received is paid from government funds, the official is an employee and wages are subject to Federal employment taxes. Examples of public officials include, but are not limited to, governor, mayor, county commissioner, judge, justice of the peace, sheriff, registrar of deeds and board members. For elected and appointed officials, you don't need to consider the

Employee or Independent Contractor?

common law rules, because the law or statute specifically identifies these positions as employee positions.

[Slide 6] Now that we've discussed worker classification rules related to Section 218 Agreements and the rules for elected and appointed officials, let's move on to rules that affect most other workers in the public sector. The Internal Revenue Code states that the term "employee" means any individual who under the usual common law rules has the status of an employee. Generally the employer-employee relationship exists when the person for whom services are performed has the right to direct and control the individual who performs the services, not only as to the result, but also as to the details and means.

[Slide 7] "The right to direct and control" is the key. Let's look at what we refer to as the control test more closely.

The tax law implements control tests in the analysis. The control test looks for evidence that the worker is subject to the entity's control as to what is to be done and how it is to be done. Under the common law test, the worker must be subject to the control of the entity. Note that under the test, the entity has the right to control the worker. It isn't necessary that the entity actually direct or control the manner in which the services are performed, it is sufficient if the entity has the right to do so.

[Slide 8] To help determine whether a worker is an employee under the common law rules, the IRS identified 20 factors that may indicate whether the employer can exercise enough control to establish an employer-employee relationship. These factors, set forth in a 1987 Revenue Ruling, were based on the circumstances that the courts identified and relied upon to decide whether an employment relationship existed. The factors are guides we can use to assess the likelihood as to whether an individual is an employee or an independent contractor. Over time, the relationship between entities and workers has changed. The conditions under which individuals provide services have made the 20 factors less relevant than they used to be for current working relationships. So the IRS established a broader frame of reference for identifying control, but the 20 factors set forth in the revenue ruling still apply. The broader frame of reference looks to three areas of control or categories of evidence to weigh when analyzing these cases.

[Slide 9] Now we look at control according to behavioral control, financial control and the relationship of the parties.

Jean Ann:

[Slide 10] Let's look more closely now at behavioral control. Behavioral evidence applies to how an outcome is achieved. These factors may include such things as scheduling and providing instructions and training by the entity. Behavioral control also

Employee or Independent Contractor?

guides whether or not the worker is free to subcontract their work to another individual. In other words, must the worker perform the services himself or herself or is he/she free to hire others to accomplish it? The amount of instruction needed varies among different jobs. Even if no instructions are given, in some circumstances, sufficient behavioral control may exist if the entity has the right to control how the work results are achieved.

Control is a matter of degree and is rarely absolute. Even in the clearest case of independent contractor, the worker is constrained in some way. For example, you might tell a construction crew that they can't start construction until school ends, however, they're still independent contractors. On the other hand, employees may have autonomy and independence in some areas. For example, your employees may have flexible working hours or be allowed to work from home some days, that doesn't make them contractors.

A business may lack the knowledge to instruct some highly specialized professionals. In other cases, the task may require little or no instruction. For instance, a physical therapist hired by a school district, requires no training from the school. The worker already has the education and training prior to being hired and the school probably isn't qualified to train the worker. In this example, instructions and training are not important. They become a neutral factor in determining whether the worker is an employee or independent contractor. Of course, you would need to consider all the other facts to make the final determination.

It's important to note when analyzing common law employment, you must look at the entire relationship. You will likely see indicators of employment status and independent contractor status in almost every case. You must weigh the factors. You can't set up columns and tally the number of employee aspects compared to contractor aspects, it doesn't work that way. You must look at the entirety of the relationship in all aspects of that relationship to come to a determination.

Various aspects are weighed differently for different positions and relationships. The final determination is based on the facts and circumstances of each particular situation. When a worker needs tools and equipment to perform a task, it becomes important who provides the tools and equipment. Let's look at the example of a snow plow driver. When the snow plow driver performs services for a township and the driver owns the snow plow, we see an indication of independent contractor status. If the driver used the snow plow owned by the township, then it would more likely indicate employee status. If no tools and equipment are necessary for a particular job, then the issue of tools and equipment becomes a neutral factor. You need to consider other factors to make the final determination. As you look at the facts, you'll decide whether they indicate

Employee or Independent Contractor?

employee status or independent contractor status or they may be a neutral factor, which is insignificant in comparison to the weight the other factors have.

The right to hire substitutes or helpers is another important control factor. If our physical therapist is so busy that she can't see all the students that she needs to, is she able to hire additional help on her own? If she can hire someone to help her and she pays that person, we have a strong indication of independent contractor status. If she must go to the school with her request and wait for them to select and pay a replacement, it indicates employee status. The key consideration under behavioral control is whether the business has retained the right to control the details of a worker's performance or has given up that right. Lori will explain the next two categories.

Lori.

Lori:

[Slide 11] Before we talk about the second and third categories, please take advantage of the opportunity to interact with us by typing in any questions that you have. We will respond by posting the responses to your questions at our video portal soon.

Now the second category. Financial control focuses on whether the business has the right to direct and control the economic aspects of the worker's activities. For example, an employee is generally paid an hourly wage or a salary with little direct correlation to their productivity in the short run. An independent contractor, on the other hand, might be paid according to contractual completion and sends an invoice to the entity for payment. Ask yourself, is this worker making an investment and incurring risk? What would an investment look like? It could include the worker purchasing equipment, materials and supplies needed to perform the services. Like the snow plow driver in the previous example, who purchased his own snow plow, or it could include investment in advertising, staff training or systems.

Financial control evaluates which party incurs the greatest economic risk. Does the worker have the ability to realize a profit or incur a loss, meaning, could the worker's business decisions result in a loss or increase in profit? An employee generally receives a set wage and has little or no overhead. An independent contractor might have set overhead expenses, such as office rent, that must be paid. A worker may or may not be reimbursed for overhead expense, such as travel, this in itself does not indicate whether the individual is a common law employee. Consider also how they are managed within this relationship. Does the worker have unreimbursed business expenses? If a worker paid for unreimbursed hotel, gas and meals on a business trip, this would indicate independent contractor status. Independent contractors are more likely to have unreimbursed expenses. An employee is probably required to complete a reimbursement request form and may need preapproval before traveling.

Employee or Independent Contractor?

An important factor to consider is whether the worker makes his or her services available to the public by advertising. Do they conduct themselves as a business interested in new customers and making a profit? Consider whether they have the time to work for others or are they spending a majority of their working hours working for one entity? You should request evidence of liability insurance or other certificates to verify their legal status as a business and to protect your own entity's level of risk. An uninsured individual may not be in business and may be deemed an employee.

[Slide 12] The third category of evidence is the relationship of the parties. This category looks for factors which reflect the intent of the parties. Can your entity refuse payment to the worker for nonperformance? An employee must be paid for the time worked. If a contractor breaches a contract term, you might be within your rights to withhold payment.

Does the worker receive benefits? Contractors don't usually receive health insurance, a vehicle to use or the right to participate in a retirement plan. Is the relationship expected to last indefinitely? If a worker is engaged with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is an indication of an employer-employee relationship. Is the worker providing a service you need on a regular basis, like a janitorial service or is it just a one-time need, like a plumber coming in to fix leaky plumbing? Is the work integral to the business?

If a worker provides services that are a key aspect of your entity's mission or business, it's more likely that the employer will have the right to direct and control his or her activities. For example, a school is in the business of educating. When the school hires a teacher, that teacher's work is integral part of the school's business. The teacher is likely to be considered an employee of the school by the IRS.

Now Jean Ann will tell us how to get assistance from the IRS using Form SS-8.

Jean Ann:

[Slide 1] Independent contractors retain certain characteristic traits, including the right to hire, the right to manage and direct workers, the right to hire a substitute, and the right to pay a substitute.

[Slide 14] Employees retain other characteristics, including: permanence of their position, benefits and the right to quit.

[Slide 15] Sometimes it's easy to determine whether a worker is an independent contractor or an employee and at other times it's not as obvious. You may wonder how the IRS would view a certain situation. If you're not sure about a worker classification issue that your entity is facing, you can complete Form SS-8 for assistance. If you send

Employee or Independent Contractor?

the Form SS-8 to the IRS, the IRS will request the same information from both the worker and the entity.

This form is available to assist in making a determination of worker status. Submitting this form to the IRS is not an examination, nor can it change the results of an examination already conducted. You can also use the form to assist your entity by asking yourself the pertinent questions, which will assist you in making a determination.

[Slide 16] Once a decision is made about a worker's classification, you need to report the payments that you've made to them throughout the calendar year. How do you report those payments? If the worker is an employee, the payments to the worker need to go through payroll. All applicable employment taxes are withheld and reported on a Form W-2 Wage and Tax Statement.

[Slide 17] And for independent contractors, follow the instructions for Form 1099-MISC, Miscellaneous Income, which may include back up withholding. A Form W-4, Employee's Withholding Allowance Certificate for Employees or Form, W-9, Request for Taxpayer Identification Number for Independent Contractors, needs to be in place prior to making a payment to a service provider.

Lori:

[Slide 18] Let's recap. How do you define an employee? Generally, the employer-employee relationship exists when the entity for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result of the work to be accomplished, but also as to the details and means by which that result is accomplished.

How can you make the determination of whether a worker is an employee or independent contractor? Well, you can make that determination by asking questions about the three broad categories of evidence, weighing the pertinent facts and determining whether those facts indicate independent contractor or employee status. How do you report payments to workers? Employee wages are reported on a Form W-2, payments to an independent contractor are reported on Form 1099-MISC.

Here are two examples which further illustrate the concepts we've been discussing:

[Slide 19] A city has an elected mayor and council members, who each receive \$100 a month and receive a Form 1099-MISC for \$1,200 at the end of the year. Should the stipend be reported Form 1099-MISC or are they wages reported on Form W-2? Elected officials of a government entity are treated as employees under the common law for FICA and by the Internal Revenue Code for income tax withholding. The mayor and council members should receive Forms W-2 and have the proper employment

Employee or Independent Contractor?

taxes withheld by the employer because the mayor and council members are employees.

[Slide 20] Here's another example. The Monday public school district has an employee who works in the principal's office full time. This employee also helps the athletic director keep the gymnasium organized and clean. For the work performed in the principal's office, the employee is paid through payroll and the pay is reported on Form W-2. The employee also receives Form 1099 for the amount he earns working with the athletic director. The employee does not have his own business.

What is the compliance obligation for this working relationship? Workers in the principal's office are generally employees of the public school district. The wages are correctly reported on Form W-2. The type of work the individual does for the athletic director doesn't change the relationship with the worker as an employee of the school district. The individual is still an employee. He's simply working in a different department of the school and taking direction from another employee. All the compensation to this employee, including wages earned for the extracurricular work, should be reported on Form W-2 and proper employment taxes withheld.

Jean Ann:

[Slide 21] The IRS and other Federal and state agencies are encouraging employers to correctly determine the proper employment tax relationship between the affected parties. The IRS has implemented a Voluntary Classification Settlement Program, also known as VCSP, to help correct worker classification issues. This voluntary program provides an opportunity for employers to reclassify their workers as employees for future tax periods with partial relief from past Federal employment taxes on compensation paid to those workers in prior periods. To participate in this program, the employer must meet certain eligibility requirements and apply to participate in the VCSP by filing Form 8952, Application for Voluntary Classification Settlement Program.

[Slide 22] The status of a worker as either independent contractor or an employee must be determined accurately to ensure that entities and workers can anticipate and meet their tax responsibilities timely and accurately.

We've almost come to the completion of our presentation today and would like to encourage you to enter any final questions that you have for us.

[Slide 23] This session was intended to raise your awareness of the worker reclassification issue by going over the factors used to weigh classification problems, how to report payments of these individuals to the IRS, how to get help from the IRS by using Form SS-8 and introduce you to the opportunity to voluntarily reclassify workers through the VCSP program.

Employee or Independent Contractor?

Should you have questions in the future on this topic or any employment tax issue, please use one of the IRS resources listed on the screen. This presentation will be available for download at the IRS video portal, along with a recording of the session and your questions, along with our responses to those questions. The website address is www.IRSvideos.gov/governments.

[Slide 24] Please join us on Thursday, April 9th at 2 p.m. eastern time, for discussion of Section 218 Exclusions. On behalf of the IRS and FSLG, thank you for joining us today. Goodbye.